



ACCOUNTING MATTERS

# Tax transparency

Raquel Meyer Alexander

*Williams School of Commerce, Economics, & Politics, Washington and Lee University, Lexington, VA 24450, U.S.A.*

## KEYWORDS

Tax transparency;  
Corporate tax  
avoidance;  
Global tax reporting;  
Tax code reform;  
Business planning  
strategies

**Abstract** As increasing pressures on government budgets lead to austerity measures, a growing number of protesters, corporate watchdog groups, and policymakers are shining the light on worldwide corporate tax avoidance. Current and proposed disclosures at the entity and country levels will pull back the veil of tax secrecy and inevitably prompt more regulatory and tax authority oversight. These disclosures could also lead to damning front-page stories and, ultimately, tax code reform. This first installment of Accounting Matters takes a close look at what tax transparency may mean for U.S. multinationals in the coming years. The article concludes with recommendations for officers and owners to manage tax and reputational risks through U.S. and international planning strategies.

© 2013 Kelley School of Business, Indiana University. Published by Elsevier Inc. All rights reserved.

## 1. Tax transparency isn't coming—It's already here

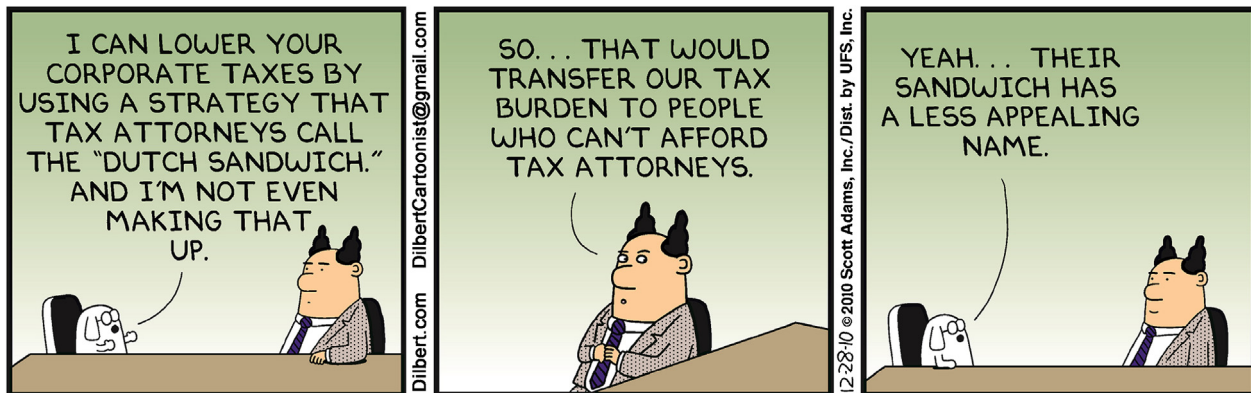
According to fashionistas, new trends start in Europe, move to the U.S. coasts, and then become mainstream in the Midwest. If these claims are true, tax directors and business owners who ignore the recent tax protests and boycotts in the UK and the G8 efforts to increase corporate tax disclosures do so at their firm's peril. Populist rage about corporations not paying their fair share of taxes is fueled by a complicated tax planning strategy which offshores profits to a tax haven with no business purpose aside from tax avoidance. Dilbert's take on Google's infamous Double-Irish, Dutch Sandwich (Figure 1) shows how complicated tax strategies can appear to the public.

During the past two decades, the corporate tax function has become more integrally aligned with firms' activities. Taxes are now a factor in business plans, compensation packages, and market valuation. For example, many executives are compensated based upon *after-tax* returns of firm activities and effective tax rate is a metric for benchmarking CFO performance. Recent academic research shows that firms that engage in aggressive tax planning are rewarded with increased stock prices (Desai & Dharmapala, 2009; Koester, 2011) and a lower cost of debt (Lisowsky, Mescall, Novack, & Pittman, 2010).

The movement of the tax function from a cost-center to a profit-center, along with an increasing global business market and a robust marketplace of tax consultants, has led to more international tax planning. Until recently, rumblings about successful lobbyists who have carved out too many tax loopholes for corporations were met with relative indifference by the public because tax rates were moving

E-mail address: [alexanderr@wlu.edu](mailto:alexanderr@wlu.edu)

Figure 1.



downward and federal/state economies were relatively healthy. But the great recession changed the rules of the game, especially for U.S. multinational corporations that find themselves now in the tax spotlight. Consider Apple Inc., which faces a shareholder lawsuit for not wisely using its cash hoard of \$137 billion, two-thirds of which is held offshore to avoid U.S. taxation. Recent reports suggest that \$20 trillion is hidden in tax havens and over \$60 billion of annual tax revenues are foregone by multinational corporations' (MNC) use of international tax strategies.

In response to austerity measures which led to significant cuts in social services across Europe, more citizens, businesses, and policymakers are reexamining tax revenues, and a new policy of name-and-shame seems to be sweeping the continent. When Amazon paid only £1.8 million (\$2.7 million) in taxes for £3.35 billion (\$5.05 billion) in sales last year, the normally staid UK citizenry was in an uproar. U.S. journalists are focusing national attention on tax planning with lists such as the Top 25 Corporate Tax Dodgers (Kristof, 2011) and the Top 10 Tax Evaders' Wall of Shame (Poe, 2011). David Kocieniewski's 2012 Pulitzer Prize for his corporate tax evasion series, *But Nobody Pays That*, gives journalists an incentive and—just as important—a template for writing about firms' corporate tax disclosures.

The consequences of public scrutiny can be intense, long-lasting, and a boardroom-level concern. In the short term, firms may find themselves subject to brand-eroding boycotts and protests; indeed, a recent study found that 34% of the UK is boycotting tax avoiders (Tax Research UK, 2013). The impact will first be felt by retailers, service providers, and manufacturers of discretionary goods. Companies seeking state and local incentives for expansion and relocation may find the target community's leaders unable to financially support companies perceived to be tax avoiders. Lobbying efforts on non-tax matters might

also be impacted when a company's tax issues makes them radioactive to politicians. For many firms, non-tax lobbying is essential to business success. For example, large manufacturers may undermine their own efforts to get regulatory relief from labor, safety, and emissions standards if they are embroiled in a public tax controversy.

In the long term, companies and entire industries may find themselves subject to increased oversight and enhanced disclosure regimes from financial and tax authorities. Expensive tax planning may have to be undone, consuming additional firm resources and racking up consultant fees. For example, Verizon—a so-called Top 25 Tax Dodger and #7 on the Wall of Shame—recently reorganized its entity structure to use Singapore, rather than a haven in the Caribbean, as an intermediary for sales. While the overall strategy is the same (i.e., use of an offshore intermediary to park worldwide profits), the optics have improved considerably. Unlike the Cayman Islands, the general public does not view Singapore purely as a tax haven. Verizon's large commercial presence in Singapore, in terms of both suppliers and markets, also provides a business purpose for use of this low-tax jurisdiction. The lengthy and expensive restructuring involved several U.S. and Singapore law and accounting firms, tied up considerable internal resources, and required the support of the C-suite.

Whereas Verizon voluntarily restructured, public scrutiny may lead to changes in the tax law which will *require* all affected firms to restructure and/or pay more taxes. In many developed nations, registered companies must provide company financial statements—frequently called 'accounts'—at the entity level. In the U.S., the SEC allows companies to file consolidated financial statements that obscure intra-company transactions (e.g., loans, royalties, management fees used to reduce tax liabilities). The EU is moving toward additional reporting at the country level to allow the public to observe

the total taxes remitted in each jurisdiction. Several U.S. bills combat offshore secrecy with information reporting, and require enhanced disclosures of employees, sales, financing, tax obligations, and tax payments on a country-by-country basis for all SEC registrants.<sup>1</sup>

## 2. Disclosures currently available, or “How did they know that?”

The disclosure regime in the U.S. and abroad is changing rapidly, and interested parties are increasingly using corporate disclosures to highlight firms. Employees of universities, the Internal Revenue Service (IRS), and other government agencies have long had access to confidential tax return data for research projects on corporate income taxation. However, all results are reported in the aggregate because individual-firm tax information derived from federal income tax filings is confidential under U.S. Treasury regulations. Although the calls for public disclosure of corporate income tax returns are falling on deaf ears, interested parties can explore new disclosures required by the SEC, the FASB, and foreign governments. Non-U.S. filings are available on country websites, such as the Netherlands’ Trade Register ([www.kvk.nl](http://www.kvk.nl)).

Unlike academic research, which seldom identifies individual companies, investigative reporters make their case through heart-wrenching stories of people affected by a company. For example, Associated British Foods—a UK multinational which owns brands including Silver Spoon, Twinings, and Kingsmill—was caught in a global tax scandal when reporters showed how transfer pricing was used to avoid paying tax in Zambia, an African state blighted with childhood hunger and malnutrition (Boffey, 2013).

The disclosures currently available vary by reporting regime, but when pieced together, can present compelling evidence of aggressive tax planning strategies. Due to significant reform in 2011, the IRS whistleblower business is becoming a cottage industry for some, with rewards of up to 30% of taxes recovered. During the 2012 fiscal year, the IRS issued 128 whistleblower rewards totaling \$125 million and received over 8,600 submissions which are working their way through the system. The financial stakes are higher and investigating international corporate tax strategies is no longer relegated to journalists on the business beat or do-gooders without expertise.

<sup>1</sup> These include the American Jobs and Closing Loops Act (H.R. 4213), the Stop Tax Haven Abuse Act (S. 506, H.R. 1265), and the Bipartisan Tax Fairness and Simplification Act (S. 3018).

## 2.1. Disclosure abroad

Required disclosures of company financial and tax information vary by jurisdiction. However, most EU and G20 countries require companies to file audited financial statements, prepared at the company level, with government authorities; these are colloquially known abroad as ‘accounts.’ Tax returns are confidential, but select tax information is presented in the accounts. Accounts are available online, and in many countries, an original audit report written in English can be downloaded free or for a nominal fee. The types of entities that are required to disclose accounts also vary by jurisdiction. For example, the Netherlands is considered a tax haven because trusts do not have to file accounts but corporations do. Using the audited accounts from a Dutch subsidiary, Bloomberg reporter Jesse Drucker (2012) discovered Google’s income was routed through a Bermuda shell company to avoid \$2 billion in worldwide taxes. Entity-level audited accounts filed in the Netherlands are publicly available and downloadable for €2.9 (\$3.80) each.

In the EU and many other developed nations, ownership information must be filed with the authorities. Many tax haven countries do not collect ownership information and others do not make such information available. With recent estimates of over \$20 trillion hidden in tax havens, new inter-jurisdictional initiatives are being developed to require tax haven countries to enhance ownership reporting.

## 2.2. U.S. disclosure

Company ownership disclosure varies by state, but Delaware and Nevada often make the tax haven list because of the level of secrecy afforded to business owners. SEC registrants face more extensive disclosure requirements. The newest tax disclosure, FIN 48, was enacted in 2007. FIN 48 enhances the financial statement tax footnotes by requiring quarterly and annual disclosures of unrecognized tax benefits (i.e., tax positions which require an accounting reserve) and changes in tax reserves due to settlements and lapses arising from expiring statutes of limitations. FIN 48 disclosures supplement the other Form 10-K information that provides tax position transparency.<sup>2</sup>

<sup>2</sup> These include FAS 109 (deferred tax liabilities), FAS 5 (loss contingencies for non-income tax related items), FAS 45 (indemnity disclosures), SOP 94-6 (disclosure when it is reasonably possible that an accounting estimate will change in the near term), Schedule II (roll-forward NOL valuation allowance accounts), and permanently reinvested foreign earnings.

But unlike the entity-level accounts disclosures in foreign jurisdictions, SEC reporting of company financial information is presented at the consolidated level so intercompany transactions are not disclosed.

The FIN 48 information is also presented on Schedule UTP (Uncertain Tax Position Statement) filed with the corporate tax return. Designed to assist the IRS during examinations, Schedule UTP requires corporations to list individual income tax positions that comprise the tax reserve presented in the financial statements. For each position, the taxpayer must identify the relevant code section(s), the EIN of any pass-through entity affected, and a description of the tax position.

### 2.3. Internal Revenue Service

The Internal Revenue Service's position on tax transparency offers one bright spot for taxpayers who aim to be compliant and cooperate with the IRS on potential disputes. Advanced pricing agreements (APA) and pre-filing agreements (PFA) offer two alternatives to the traditional post-filing dispute process. The IRS's long-standing APA program is a binding contract between the IRS and the taxpayer to treat specified international transfer price transactions in an agreed-upon manner. The IRS PFA program was initiated in 2002, allowing a taxpayer to reduce costly and time-consuming disputes in an audit by requesting consideration of a tax issue before the return is filed. In 2012, the Service received 33 PFA requests, accepted 12, and reached 10 closing agreements. Increasing tax transparency with the IRS, through formal programs such as APA and PFA and through informal interactions, can reduce monetary and reputational risks arising from tax controversies. Further, these agreements eliminate uncertainty and, by corollary, eliminate FIN 48 and Schedule UTP disclosures on these transactions.

Another recent development is the U.S. Treasury's Foreign Account Tax Compliance Act (FATCA), a unilateral effort to impose reporting and withholding requirements to reduce banking secrecy. FATCA requires U.S. taxpayers to report foreign financial assets over certain amounts to the IRS and foreign financial firms to disclose U.S. clients.

### 2.4. Harmonization and cooperation

The international community is confronting tax evasion through information sharing. Tax treaties are being revised to include tax information exchange agreements; the Organization for Economic Cooperation and Development (OECD) Global Forum on Transparency and Exchange of Information for Tax Purposes has 120 member countries. The number of

active information requests between nations is at an all-time high and countries normally recalcitrant to participate (e.g., Japan, Brazil) are getting on board. Many more countries have entered into bilateral agreements with key trading partners. Even developing nations, such as those in Africa and Central America with less sophisticated taxing authorities and fewer resources directed toward tax collections, are establishing tax information sharing initiatives. In early January 2013, tax authorities from the BRICS (Brazil, Russia, India, China, and South Africa) pledged to share information and tax collection practices with each other.

The G8, a group of finance ministers and central bank governors from eight major economies, has made international taxation reform the central issue for 2013. The 2013 G8 chair is pro-business, conservative British Prime Minister David Cameron, who has surprised many by vowing to combat aggressive tax avoidance by international companies and likening it to illegal tax evasion. In 2011, the G20 committed to the multilateral Convention on Mutual Administrative Assistance in Tax Matters. In 2012, a less splashy—but just as important—change was approved to make tax evasion a predicate offense for money laundering. In other words, the nimble money laundering statutes with relatively low burdens of proof and favorable mutual assistance treaties can now be applied to tax evasion.

Individual initiatives to harmonize international tax regimes and increase transparency are also appearing. UK Parliament Member Stephen McPartland sent letters to the top 100 FTSE companies requesting that they sign on to tax transparency initiatives via a tax challenge that promotes country-by-country reporting. The responses he received may be categorized into two groups: (1) companies with tax planning strategies that do not think country-by-country reporting will improve transparency, and (2) companies with little international presence that fully support the initiative.

## 3. Prospects for long-term tax transparency

The single-largest change on the horizon is implementation of country-by-country reporting. On February 28, 2013, the EU Parliament approved country-by-country reporting for European banks starting in January 2014. These confidential reports will include data on employees, profits, and taxes paid in each jurisdiction, along with subsidiary ownership information.

The Dodd-Frank Act specified that SEC registrants in an extraction industry must annually report payments made by the company, its subsidiaries, or

entities under its control to the U.S. and foreign governments by project and by country. The payments subject to disclosure include taxes, royalties, bonuses, dividends, and infrastructure improvements. For each payment, companies must provide the type and amount paid on a cash basis, the total for each category listed above, the government and country that received the payment, and the projects to which the payments relate.

Other transparency initiatives include Publish What You Pay. This idea is promoted by a number of public interest groups and entails required, comprehensive country-by-country reporting of all government payments made by multinational organizations, whether public or privately held. Executives should anticipate that the country-by-country reporting required of EU financial institutions and U.S. extraction enterprises will be imposed by more jurisdictions—including U.S. states—on more industries.

## 4. Recommendations

### 4.1. Don't let the tax tail wag the dog

This is a good time to consider restructuring based upon business models, not tax efficiencies. Tax consultants often devise clever names to give the appearance of a business purpose, but the IRS and the Tax Court will likely know that 'tax-efficient supply chain management' is really just tax sheltering with a fancy name. Examine the subsidiaries listed on Form 10-K, Exhibit 21 (Subsidiaries of the Registrant) with a keen eye toward those located in known tax havens. To reduce exposure, many large multinationals are engaging in synthetic mergers to eliminate inactive subs and those in tax havens. As the consumers of tax shelters hawked by accounting firms, investment banks, and lawyers in the 1990s and 2000s discovered, taxing authorities can distinguish between real investments and transactions without economic substance. Further, recent settlements involving Ernst & Young, KPMG, and PWC require the firms to disclose tax shelter information to the IRS so corporations engaged in the most risky transactions have lower odds of winning the audit lottery.

### 4.2. Don't treat the symptom, cure the disease

Executives should consider becoming involved in tax policy at the national and international levels. While lobbyists are helpful in getting access, owners and managers who tell the story of their company's tax issues are often more persuasive to policy

makers and elected officials. The tax issues likely to be up for debate are identified in *Addressing Base Erosion and Profit Shifting* (Organization for Economic Cooperation & Development, 2013) as key pressure points in international corporate tax reform: related party debt, captive insurance, intergroup financial transactions, transfer pricing between related entities, thin capitalization rules, tax treaty abuse, and preferential regimes. Executives would be well served to work on leveling the playing field in international tax rather than investing more resources in short-term fixes, such as tax planning strategies.

There is no shortage of opportunities to get involved in tax policy. This year, three OECD taskforces are working on international tax issues. Britain chairs one on transfer pricing, Germany chairs the tax-base erosion group, and France and the U.S. co-chair a taskforce on jurisdiction issues with emphasis on e-commerce.

Executives should also consider engaging in the debate about transparency. Recent initiatives in the U.S. and abroad call for country-by-country reporting of sales, profits, and taxes paid in every jurisdiction where an entity operates; automatic exchange of tax data through international tax cooperation among governments including non-resident individuals, corporations, and trusts; and public disclosure of beneficial ownership of all business entities, trusts, foundations, and charities.

### 4.3. Get ahead of the press. . .and stay there

Employees charged with media and investor relations should be informed of transactions and tax matters that may raise eyebrows among regulators, the media, and the public. Help these employees be prepared for inevitable questions, such as:

- How much in taxes do you pay in X jurisdiction?
- How do you keep your tax rates lower than the statutory corporate tax rate?
- Why did you pay your CEO—or lobbyist, or private jet pilot, and so on—more than you paid in taxes?

Executives should be ready with an explanation that addresses the business reasons behind the low tax rates, and take a lesson from the responses of General Electric (GE) and Electronic Arts (EA) when each was the focus of a tax avoidance story by the *New York Times*. GE kept the news cycle going with varying explanations, while EA gave a response that (1) highlighted tax law designed to support new



technology industries, lowering the company's tax rate; and (2) summarized the other taxes EA pays, along with the number of individuals its employs in the United States. Because of the great potential for misunderstanding complex financial data, companies should strive to present tax information in a useful way to the public.

Executives should also publicly recognize the problem—no outright denials—while reassuring the public and constituents that the company will consider changes in tax planning. Throwing blame on tax laws and tax administrators is not effective, nor is stating that the IRS agreed to the transaction in advance. The public is only angered by one response: "Don't hate the player; hate the game." Recall that Richard Nixon released the results of his clean tax audit in hopes of assuring the public that he was not a crook. This, however, just provided more fodder for the press and led to increased scrutiny of his other extracurricular activities. A second audit revealed a significant deficiency and, of course, the press did not let go of the Watergate story.

#### 4.4. Tax transparency as a strategy

Executives might consider how to use transparency to the firm's advantage. In general, new initiatives are phased in slowly, allowing smaller firms time to adapt to the changing reporting regime. Consider whether or not your firm will be an early adopter. Research shows that the market does not necessarily reward voluntary disclosures, even when they are verifiable (Ronen & Yaari, 2002).

Tax transparency is certainly being met with resistance, as evidenced by the aforementioned responses to MP McPartland's tax challenge. It should be noted that tax transparency itself won't necessarily lead to increased tax revenues. It is more likely that tax transparency will change the competition between countries, states, and localities for economic development, but the competition will not go away. With access to competitors' disclosures, executives may be able to strategically position their company for business incentives. For example, firms with more employees than their competitors in a particular jurisdiction may find elected officials amenable to property and sales tax abatements.

Tax transparency accompanied by international tax reform may also provide opportunity for a tax director to clean up all the company's tax strategies that do not serve a legitimate purpose. Because all firms will be subject to the same rules, the market will likely not penalize any firm during the adoption period. For example, research shows that firms with

large FIN 48 disclosures upon adoption in 2007 did not, in general, suffer from a negative market reaction.

## 5. Conclusion

Tax transparency has been a hot-button issue throughout the world, and multinationals are now being targeted for aggressive tax sheltering activities. While Americans take pride in the success of U.S. companies doing business abroad and rely upon these profits to fund the retirements of American workers, foreigners clearly hold a different opinion: United States-based MNCs are often viewed as predators that steal sales from local businesses, use local services, skirt tax obligations, and hide profits in tax havens to enrich wealthy U.S. shareholders. Consider the case of Vodafone—a British telecommunications giant—in India. After battling Indian tax authorities' charge that the firm owed taxes stemming from an acquisition, the Indian Supreme Court finally ruled in favor of Vodafone in 2012. Rather than acquiesce, however, the Indian government simply voted to change tax law—retroactively back to 1964—so that Vodafone remains liable for the tax assessment ("Vodafone," 2013). Given that India is providing guidance to Chinese, Brazilian, and Russian taxing authorities, United States-based MNCs should not be surprised to find that current tax planning strategies are increasingly ineffective. In sum, U.S. executives should resign themselves to new disclosure regimes, both domestically and abroad, and look for opportunities to use these inevitable changes to their firms' strategic advantage.

## References

- Boffey, D. (2013, February 9). British sugar giant caught in global tax scandal. *The Guardian*. Retrieved from <http://www.guardian.co.uk/business/2013/feb/09/british-sugar-giant-tax-scandal>
- Desai, M., & Dharmapala, D. (2009). Corporate tax avoidance and firm value. *Review of Economics and Statistics*, 91(3), 537–546.
- Drucker, J. (2012, December 10). Google revenues sheltered in no-tax Bermuda soar to \$10 billion. *Bloomberg*. Retrieved from <http://www.bloomberg.com/news/2012-12-10/google-revenues-sheltered-in-no-tax-bermuda-soar-to-10-billion.html>
- Koester, A. (2011). *Investor valuation of tax avoidance through uncertain tax positions* (Working Paper). Seattle, WA: University of Washington.
- Kristof, K. (2011, August 31). Top 25 corporate tax dodgers. *CBS Moneywatch*. Retrieved from [http://www.cbsnews.com/8301-505144\\_162-36945095/top-25-corporate-tax-dodgers/](http://www.cbsnews.com/8301-505144_162-36945095/top-25-corporate-tax-dodgers/)
- Lisowsky, P., Mescall, D., Novack, G., & Pittman, J. (2010). *The importance of tax aggressiveness to corporate borrowing costs* (Working Paper). Champaign, IL: University of Illinois.

- Organization for Economic Cooperation and Development. (2013). *Addressing base erosion and profit shifting*. Paris: OECD.
- Poe, C. (2011, April 10). Top ten list: Tax evaders' wall of shame. *The Washington Times Communities*. Retrieved from <http://communities.washingtontimes.com/neighborhood/ad-lib/2011/apr/10/tax-evaders-wall-shame/>
- Ronen, J., & Yaari, V. (2002). Incentives for voluntary disclosure. *Journal of Financial Markets*, 5(3), 349–390.
- Tax Research UK. (2013, March 1). *34% of the UK is boycotting tax avoiders*. Retrieved from <http://www.taxresearch.org.uk/Blog/2013/03/01/34-of-the-uk-is-boycotting-tax-avoiders/>
- Vodafone gets India tax office reminder on \$2 billion tax dues. (2013, January 5). *Reuters*. Retrieved from <http://www.reuters.com/article/2013/01/05/india-vodafone-tax-idUSL4N0AA0D420130105>